



# The need for fiscal discipline

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**Breakdown of fiscal discipline in Papua New Guinea has resulted in macroeconomic problems, despite high and growing levels of resource rents. It is recommended that the proposed National Economic and Fiscal Commission become an independent organisation, accountable only to Parliament, with broad fiscal review powers to monitor and advise on fiscal policy and to increase the transparency and public discussion of the national budget.**

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## Recent fiscal reforms

The Chan/Haiveta government has initiated some fundamental changes since coming to office in August 1994. The decision to devalue the kina in September followed by a float in October 1994 represented the official end of the era of the 'hard kina policy'. Although the decisions to devalue and float the kina were forced by circumstances relating to the low level of foreign reserves, caused in part by significant capital flight, the change was also seen to be necessary given the expansionary nature of fiscal policy in the 1990s. A cash flow problem, which was a direct consequence of the expansionary fiscal policy, had to be addressed simultaneously. Strict expenditure controls, introduced in the March 1994 mini-budget,

had to be reinforced and strictly monitored throughout 1994 and into 1995. A wage freeze was also introduced as part of this crisis management package. A number of other initiatives, promising public sector reforms, greater deregulation and liberalisation, were also announced in the 1995 Budget.

These changes are the beginnings of a reform process aimed at creating a more competitive economy so that Papua New Guinea can compete more effectively in world trade and investment and establish a more efficient public service to support the government in its service delivery and management functions. Papua New Guinea is fortunate to have the benefit of the experiences of other reforming countries. The overwhelming evidence from these experiences is that the benefits from such

reforms outweigh their costs. It makes sense that Papua New Guinea should also begin this reform process and see to it that it is fully implemented.

## **Fiscal indiscipline**

There has been much international and local attention focused on Papua New Guinea's financial problems over the last 17 months. A commonly asked question is: Why does Papua New Guinea have these problems when it has rich mining, petroleum, fishery and forestry resources; particularly since the recent development of these resources has generated unprecedented levels of resource rents?

A number of factors have contributed to the current financial problems in Papua New Guinea. The first of these can be seen in the trend of Papua New Guinea's national budget expenditure since 1990 (see Gupta, this issue), where expenditure has been consistently greater than the amount of revenues raised. As a result, Papua New Guinea's public debt has grown from 1,470.1 million kina in 1990 to 2,867.8 million kina in 1994, with no real effort to contain it, even if this opportunity was available from substantial resource revenues (Bank of Papua New Guinea 1994). The promise of lucrative revenues from mining and petroleum resulted in unprecedented increases in the level of government expenditure, averaging 10 per cent per year since 1991 and ranging from -1.4 per cent in 1994 to 18.2 per cent in 1993 (Papua New Guinea 1995). The negative figure for 1994 is a reflection of the expenditure cuts and controls imposed in that year. Expenditures on public service salaries and wages increased by about 93 million kina over this period with little or no increase in the numbers employed. A number of other growing expenditure areas were also largely political, namely free

education, village services, the electoral development fund and crop price support. In the case of crop price support, the actual level of expenditure was double the amount budgeted. The long-term neglect of public infrastructure also meant that greater attention had to be given to maintenance expenditure. Maintenance has always had low priority, given the attractiveness, at least to politicians, of new infrastructure projects rather than maintaining existing ones. In 1994, a special allocation of 28 million kina was made for maintenance expenditure (Papua New Guinea 1993).

The promise of mining and petroleum revenues also led to the decision to substantially reduce tax rates in 1993, especially company and personal income taxes. Company tax was reduced from 35 per cent to 30 per cent while the marginal income tax rate was reduced from 45 per cent to 28 per cent. The reduction in the income tax rate saw income tax revenue decline by about 47 million kina in 1993. The marginal income tax rate has since been increased to 35 per cent. Such a reduction in revenues, however, could not have created problems if revenue forecasts were less optimistic and revenue collection and expenditure control were more effective.

High levels of government expenditure are not necessarily bad policy if the extra expenditure is directed towards capital rather than recurrent expenditure. Papua New Guinea's experience, however, has been one where the latter has grown at the expense of the former. The Papua New Guinea High Commissioner to Australia, in his address to the Australian Institute of International Affairs in Canberra, described this policy as 'raids' on the capital budget (Reiher 1995). Poor implementation capacity has often created large pools of unused funds which become easy prey for such 'raids'. This capacity problem has also

contributed to what has been termed the 'loan drawdown problem', particularly in relation to concessional funds. This problem has been quite severe, especially given the fact that Papua New Guinea has recently found it extremely difficult to borrow externally. Relief has been sought in borrowing from the domestic financial sector, creating additional monetary problems in the economy.

The second troublesome factor also relates to expenditure levels. As well as planned expenditures growing rapidly, there has been consistent over-budget expenditure in recent years. Although certain areas of over-expenditure were justified—for example, Bougainville restoration and other disaster relief operations—a substantial part of this over-expenditure reflected a general lack of expenditure control and monitoring in the budgetary process. Government departments often spent more than their allocations because of the absence of timely controls. Penalties have always been in place for departments which overspend but enforcement has generally been lacking. Sometimes enforcement is so delayed that personnel changes often prevent the imposition of penalties. This lack of control is an example of the 'weak state' phenomenon that has been used to describe the state in Papua New Guinea (see Larmour, this issue). Over-expenditure is not unexpected in a political environment like that of Papua New Guinea, where each parliamentary member is operating to redirect as much of the government's resources as possible to his (rarely, her) electorate. In addition, the system of expenditure control is one where there is little incentive to save. Departments which under-spend their allocations are likely to be penalised by these amounts in the following budget.

The third factor to explain the financial problems is the government's preference

for equity participation in resource development projects. The financing arrangements for equity participation have been such that the state has not been able to draw direct benefit from its equity share, especially from the more recent projects. The same is also true for landowner groups. Financing arrangements for equity participation allow for loan repayments to have first call on project revenue flows. The magnitude of the principal amounts borrowed has meant that a substantial share of equity revenues is pre-committed for loan repayments. This means that state revenues from resource projects have more or less been limited to tax revenues which include company tax and dividend withholding tax. But, as stated earlier, these have been used in financing the expansionary national budgets and providing tax concessions, incentives and subsidies.

The use of mineral revenues to finance expansionary budgets has been made possible by changes to the Mineral Resource Stabilisation Fund (MRSF) Act which allowed larger amounts to be drawn from the Fund to support national budgets. In hindsight, if the MRSF had been protected, substantial savings would have resulted and the current financial problem could have been avoided.

The lack of services to much of rural Papua New Guinea is a manifestation of how the national government has failed to utilise the resources at its disposal. The current provincial government system is being blamed for this failure—hence the proposed reforms to this system. But as Axline (1993) and Peasah (1994) argue, insufficient financial transfers, relative to the transferred functions themselves, have restricted the ability of provincial governments to deliver services effectively.

A great deal of fiscal indiscipline has been displayed over the past four years.

Wasteful and increasing recurrent expenditure, consistent over-budget expenditure, raids on capital budget allocations, the invasion of the MRSF, and disregard for the increasing public debt are manifestations of this indiscipline. The prospects for increased revenues from resource projects seem to be the immediate cause of this indiscipline in the fiscal operations of the government. But, at a more basic level, there appears to have been a loss of fiscal oversight and transparency that had been provided by the public service.

### Re-introducing fiscal discipline

The challenge for Papua New Guinea lies in being able to ensure that resource revenues are not wasted on recurrent expenditures; that instead they are put to productive use, meaning invested wisely. If this cannot be guaranteed, then opening up more resource projects will only create a greater burden for the country over the long run. Greater fiscal discipline is needed if Papua New Guinea is to withstand similar pressures in the future. Although much of the recent indiscipline originated at the political level of government, the fact that the administrative layer of government could not resist it, knowing its potential dangers, is cause for concern. The loss of the usual form of fiscal control in the form of a strong finance department, and the prospect of continuing pressures for the distribution of resource rents as consumption rather than investment, suggests that extraordinary measures need to be taken. This view is reinforced by the difficulty nearly all other resource-rich developing economies have had in seeing that resource rents are invested wisely.

Seeing that fiscal discipline is likely to be difficult to exercise from within the

existing political and administrative levels of government, what is needed is an independent body, external to any authority of government, and responsible only to parliament, whose prime responsibility is to ensure that fiscal discipline is maintained. The current provincial government reform proposals suggest the revival of the National Fiscal Commission as the National Economic and Fiscal Commission (NEFC) with fiscal powers to distribute revenue between provincial governments (Temu 1995). While supportive of its revival, we suggest that this organisation should be given an independent status and accorded much broader fiscal review powers—to not only monitor and advise on fiscal policy, but also to evaluate economic policy and oversee the implementation of the national budget by reporting regularly and publicly to parliament. Its public reports would hopefully attract considerable media attention and thereby broaden and deepen public understanding of the fiscal affairs of government. Its independent status would be greatly enhanced if eminent economists were appointed to the NEFC. It should be served by a small secretariat but have full access to government documents. Such an independent body would do much to improve the transparency and quality of policymaking in Papua New Guinea and to improve policy stability. Policy stability, so important to investment and economic growth, is difficult to achieve under a situation of severe financial stress as seen in Papua New Guinea in recent years.

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